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Monthly Letter on

Economic Conditions Government Finance

New York, June, 1953

General Business Conditions

TRADE and industrial activity during May have held at the high rates of preceding months. Despite earlier skepticism, and more recent fears that tightening credit might prove depressing, it is clear that the spring season as a whole has been the most active that the country has ever enjoyed, and that business is still moving along, even at these high rates, under good momentum and with strong supports. Commodity prices are no more than steady, on the average, and buying policy is conservative. Nevertheless, new orders in most industries seem to be running equal or close to shipments, with the result that order books stay well-filled. The index of industrial production has leveled out since its rapid rise during the winter, but chiefly because there is no longer much room for it to go up. Unemployment is subnormal; labor is short in some areas; and a good deal of overtime work is reported.

At the current level of 242 (1935-39=100) the Federal Reserve Board's production index is 20 to 25 points above the spring months of 1952. The greatest gains have been in consumers' durable goods and in steel and other materials used in them. Earlier skepticism about the business outlook centered on consumers' durables, for many people feared that by the end of the spring production of automobiles and household goods would be overdone and dealers overstocked. Thus far, however, evidences of weakness have been confined to a few appliances. Sales of automobiles have held up remarkably. While conditions are not the same for all makes and in all areas, manufacturers of popular models complain that they are losing business because they cannot keep enough cars on dealers' floors. It appears that the people who were most nearly right on the automobile sales outlook, at the beginning of the year, were those who were most optimistic.

Even used car markets, despite reports of "full lots" and spotty conditions, are holding better than the pessimists expected. Indexes of used car prices show only a slight downtrend, and in relation to new car prices they are still substantially above what, in prewar years, was thought to be normal.

Record Output and Consumption

In the main, the record-breaking output of goods appears to be moving steadily into consumption. In refrigerators and a few other household items some overstocking and curtailment of operations are reported. The market for motor trucks and tractors seems to be fully supplied. Tire inventories are full, although manufacturers do not consider them out of line with requirements. Instances of cutbacks in operations due to accumulation of stocks, however, are not numerous. Retail trade in recent weeks has been excellent. For the month of April, total retail sales were 7 per cent above a year ago, with durable goods sales up 15 per cent and nondurables up 3 per cent. Department store sales recently have shown satisfying increases.

CONTENTS

In the sharp rise of production that occurred last fall, inventory accumulation, as measured by Department of Commerce statistics, for a time reached a rate of $8 billions annually. This was excessive and if it had continued into 1953 it would have been a justifiable cause of concern. It is clear, however, that some of the restocking was the necessary replenishment of inventories drawn down during the steel strike. Since the first of the year the rate of accumulation has slowed to $2.5 billions annually, or less, while sales have climbed. Stock-sales ratios, according to latest figures, were lower than a year ago.

This moderation of the inventory buildup is all to the good. To be sure, a reasonable stock-sales ratio is not a final answer to the concern sometimes expressed about the $75 billion aggregate which inventories have reached; for if sales should slacken, the ratios would rise quickly. But large inventories are needed to carry on business at present rates. A large fraction of total stocks — and the part where increases have been greatest — comprises goods in process held against defense orders which have a long production time.

Elements of Stability

The month's news has thrown little light upon a question of major interest, namely, whether tightening credit is beginning to limit either business programs for plant and equipment expenditures or instalment purchases of consumer goods. So far the evidence is that business investment continues stable, and that the figures for the second half year will hold current record levels. Active automobile business and high retail sales generally are indications that instalment purchases are probably still expanding. In another area, President Eisenhower's budget speech indicates that government demands for goods and services during the fiscal year 1954 will be at almost exactly the same rate as at present.

In short, little significant slackening in business is to be seen, and little evidence of weakening of the forces which have supported trade and industrial activity this spring has appeared. Many suspect, and with good reason in view of consumer credit expansion, that the markets for consumers' durable goods are borrowing from the future, and that a reaction will originate in these industries, perhaps spreading further. But strong supporting influences evidently will be present for months ahead. Not the least of these influences is the extent to which reaction is being anticipated, through cautious buying.

The President's Tax Proposals

Last month President Eisenhower, in a radio address to the Nation and a message to the Congress, disclosed his eagerly-awaited tax proposals for the fiscal year 1954 starting next July 1. Revealing that, despite substantial progress in cutting expenditures, the Treasury under existing tax legislation will still face a large deficit, the President ruled out tax reductions for this calendar year, and asked for the continuance of certain taxes due to expire in 1954, as indicated by the following 5-point program:

(1) Extending the corporate excess profits tax six months beyond its present limitation, June 30, 1953.

(2) Permitting the scheduled decreases in personal income taxes on December 31, 1953, but not advancing the date to June 30 as contemplated in the Reed bill.

(3) Repeal of the scheduled 5 per cent reduction in the regular corporate income tax on April 1, 1954.

(4) Repeal of the scheduled reductions in excise taxes on April 1, 1954, pending further study of the whole excise tax structure.

(5) Postponement for one year of the increase scheduled January 1, 1954 in the old-age security tax from 1½ to 2 per cent. This in view of the large accumulations already in the social security reserve fund and the fact that current receipts are in excess of expenditures.

The President expressed deep regret at the necessity of postponing tax relief, but called for an honest facing of the facts, warning that "to accept a great revenue loss at this time would be to insure longer life to bigger federal deficits and greater eventual danger to the country." He stated the Administration's convictions in the field of fiscal policy in these words:

> We believe that — for the long term — present taxes are too high. We think they are becoming a real threat to individual initiative.
>
> We believe, at the same time, that no citizen — once satisfied that his government is operating with honesty and economy, and planning with foresight — wants any tax saving at the price of essential national security.
>
> We believe — finally — that our truly urgent need is to make our nation secure, our economy strong, and our dollar sound.
>
> For every American this matter of the sound dollar is crucial. Without a sound dollar, every American family would face a renewal of inflation, an ever increasing cost of living, the withering away of savings and life insurance policies.
>
> An immediate tax reduction and bigger deficits, which would in turn inflate the dollar still more, would cheat every family in America. It would strike most cruelly at the poorest among us.
>
> The balancing of the budget is, therefore, vital — not merely as some abstract, statistical feat to be performed by government accountants — but to help give each citizen the kind of dollar with which each family in the nation can begin balancing its own budget.

The Budgetary Background

Supplementing his proposals on taxes, the President reviewed briefly the budgetary situation inherited from the previous Administration and the progress made in bringing expenditures under control.

As he explained, the budget presented by President Truman in January called for expenditures in fiscal '54 of $78.6 billion, and an excess of expenditures over receipts of $9.9 billion.

But that, he pointed out, was only part of the story.

First, revised estimates now indicate that revenue collections for fiscal '54 are likely to fall some $1.2 billion below those previously budgeted, thus raising the indicated deficit above $11 billion.

Second, the Truman military budget made no specific provision for continuance of the Korean war or for further building up of Republic of Korea divisions.

Third, the Administration will face, as of this June 30, a carryover of $81 billion in authorizations to spend, for which cash must be found over the next few years. Since most of that sum is already under contract, largely for defense purposes, there is little scope for immediate economies in that area.

Despite these formidable obstacles, the President announced important progress in cutting expenditures and reducing the deficit. As a result of rigorous combing over of all expenditure programs, the Administration has already succeeded in reducing by $8.5 billion the recommended total of new appropriations. While budget expenditures cannot be reduced immediately by this full amount, due to carryover of outlays obligated in previous fiscal years, the actual saving in fiscal '54 comes to $4.5 billion.

Giving effect to these substantial savings, the indicated deficit set at $9.9 billion in the Truman budget, and raised to over $11 billion by downward revision of revenue estimates is reduced to $6.6 billion on the usual budget basis.

The foregoing calculations were made on the assumption that the various reductions in tax rates will take effect as now scheduled under the law. Such reductions will give up revenues in fiscal '54 to the extent of an estimated $2.1 billion, but in a full year thereafter will cut revenues by an estimated $8.0 billion. Moreover, to advance to June 30 the scheduled reduction in personal income taxes, as proposed in the Reed bill, would cut revenues in fiscal '54 by an additional $1.5 billion and raise the deficit accordingly.

Effects of Eisenhower Proposals

To strengthen revenues over the period immediately ahead, the President proposed raising $800 million of additional revenue by extending the corporate excess profits tax from June 30 to December 31, 1953; raising $2 billion annually by repealing the scheduled reduction from 52 to 47 per cent in the regular corporation income tax; and raising $1 billion annually ($200 million in fiscal '54) by repealing the scheduled reductions in excise taxes. He expressed willingness to let the reduction in personal income taxes go into effect December 31, as scheduled, but strongly rejected the proposal to advance by six months the effective date. The postponement for one year in the scheduled ½ of 1 per cent rate rise of the social security tax, amounting to $500 million in fiscal '54, would not affect the regular or "administrative" budget, but would reduce the funds available to be borrowed from the trust fund.

It will be seen from the following table that after giving effect to these changes, the Treasury would still face a deficit in fiscal '54 of $5.6 billion in the administrative budget and $2.8 billion on a cash basis.

Budget Outlook Fiscal Year 1954

(In Billions of Dollars)

	Budget Expenditures.	Budget Receipts.	Deficit Administrative.	Deficit Cash.
January budget, past Admin.	78.6	68.7	9.9	6.6
Revisions in estimates	— 4.5	— 1.2	—3.3	—3.8
Rev. budget, with sched. tax reductions	74.1	67.5	6.6	3.3
Effect of recom. changes in taxes from rates now sched. to become effective	—	+ 1.0	—1.0	—*.5
Revised budget	74.1	68.5	5.6	2.8

* Difference between effects on administrative and cash budgets is explained by a reduction of $500,000,000 in old-age insurance tax receipts.

These figures explain all the more clearly why the President was unwilling to accept the estimated revenue loss of $800 million from permitting the excess profits tax to expire this month, and the loss of $1.5 billion from advancing the scheduled decrease in personal income taxes. Even the scheduled reduction in the latter next January will be justified, he stated, "only because of reductions in proposed expenditures which the present administration has already been able to make and because of additional economies we expect to achieve in the future."

A Hard Decision

In the case of the excess profits tax, the President faced a particularly hard decision. It involved questions of principle between prolong-

ing the life of a bad tax and giving up any tax so long as the budget remained unbalanced.

That the President is aware of the evils of this tax is indicated by the following from his message to Congress:

> Though the name suggests that only excessive profits are taxed, the tax actually penalizes thrift and efficiency and hampers business expansion. Its impact is especially hard on successful small businesses which must depend on retained earnings for growth. These disadvantages of the tax are now widely recognized.

Not only is the excess profits tax recognized as a bad tax, but the estimated $800 million involved in a six months extension would be comparatively small in relation to the whole budget. Furthermore, there is a great deal of doubt as to the accuracy of even this figure, due to the tendency of the tax to discourage undertaking new ventures and to encourage wasteful practices, thus cutting the corporate earnings subject to both this tax and the regular income tax. Bringing up at all in Congress the matter of excess profits tax extension will open up the field for almost unlimited amendments to reduce inequities, with the possibility of still further loss in yield.

On the other hand, the President had to consider the approaching deadline for decision on this tax, the need for more time in effecting economies in expenditures, and the fact that both Treasury and the House Ways and Means Committee are engaged in studies looking toward a completely revised program of taxation to come up early next year. Moreover, there was the practical difficulty of finding a stopgap substitute for the excess profits tax that Congress could agree upon, and the strong political objection in Congress to letting the excess profits tax die without making effective on the same date the individual income cuts costing an additional $1.5 billion, or definitely more than the Treasury could afford to lose.

In resolving the dilemma, by asking for the limited extension of this tax, the President explained that he "would not advocate its extension for more than a matter of months," but nevertheless felt that "under existing circumstances the extension of the present law is preferable to the increased deficit caused by its immediate expiration or to any short-term substitute tax."

The Longer-Range Tax Program

The President described the purpose of a general tax overhaul as "to remove existing inequities of our tax structure, simplify the needless complications which have developed over the years in tax laws, and generally secure a better balance of tax revenues."

In line with this objective, Secretary of the Treasury George M. Humphrey, in a press interview, confirmed the President's implied promise a few days earlier that the Administration would not ask for a further extension of the excess profits tax beyond December 31. He indicated that, while no decision had been made, the Treasury is "considering" a national sales tax as an alternative to E.P.T. and other taxes that are due to expire.

The proposal for repeal of the scheduled decrease in the regular corporate income tax next April is one on which judgment may well be suspended pending the outcome of continuing efforts to prune government expenditures. Also, by next spring it will be possible to have a clearer idea of the trend of corporate earnings and tax revenues. The President in his tax message to Congress conceded that "a 52 per cent corporate tax rate is too high for the long run."

A similar view was expressed by the Canadian Minister of Finance, D. C. Abbott, in his budget speech in 1951 when he stated:

> I say quite frankly . . . that I am not happy about corporation tax rates when they go over 50 per cent. I think it is bad psychology to permit people to say that more than half of any income earned, or any savings made will go to the government.

Although in 1952 Canada was forced because of the Korean war expenditures to raise the basic corporation rate to 50 per cent as an emergency measure, that rate was reduced this year to 47 per cent. We ought not to continue the present high U.S. tax rates on corporate earnings any longer than is absolutely necessary.

Judgment may also be deferred on the proposal to rescind the scheduled decreases in excise taxes, pending the presentation to the Congress of the Administration's specific program for reform of the whole excise tax structure. As the President said, "The wide variety of existing excise rates makes little economic sense and leads to improper discrimination between industries and among consumers." A national sales tax, levied broadly, would meet many of these objections. It might be used not only as a substitute for some of the present excise taxes, but also as a means of raising additional revenues. With over 80 per cent of our total revenues now derived from corporate and individual income taxes, this would bring about a better balance in the overall tax structure.

Economy the Key

But talk of tax relief will not get far unless government expenditures are drastically reduced. This is true not only of efforts at tax reduction *per se,* but also of efforts at tax reform, since

changes to eliminate inequities usually involve giving up some revenue.

It is an old story that most everybody wants economy in government as a matter of principle, but trouble comes with the attempt to put precept into practice. Then protests mount as individual groups find their toes being stepped on by specific economy proposals. Reports in the press indicate the present to be no exception. There are major differences of view over the magnitude and character of the proposed cuts in defense expenditures. But apart from these is the flood of objections to proposals for economies ranging through the non-defense classifications. As one example, Representative Norris Cotton of New Hampshire reports that he is being deluged by letters, telegrams and telephone calls from constituents who think they are getting hurt from economy moves made so far. Writing in a weekly newsletter to the people back home, he says:

> I'm getting wires about the reduction of federal appropriations. A Grange sends me a resolution against lopping off of money for agriculture. A pulp company executive is concerned over the scaling down of forestry funds. A business association deplores discontinuance of our industrial census. A nursery is worried about control of the Japanese beetle.

"It's not very nice to think," Mr. Cotton wrote, "that economy may be political suicide."

It is of course right and proper that there should be careful scrutiny of proposed budget reductions to avoid so far as possible cutting really essential outlays. But it must be remembered that the departmental requests have been reviewed by the Bureau of the Budget and subjected to further scrutiny by the Appropriations Committees of the Congress, now equipped with a staff of experts for such study. The fact remains that people cannot get the tax relief they want unless the budget is cut somewhere; and that means not just the projects favored by the "other fellow". As President Eisenhower said in his radio address:

> Government cannot do this job — any more than any other job — utterly alone. You and your fellow-citizens who want your Government to spend less must yourselves practice self-restraint in the demands you make upon Government. You as citizens cannot help the common cause by merely favoring economy for every group except the one to which you belong.

Treasury Financing

With the $1 billion thirty-year 3¼s sold May 1 fluctuating in a range between 99¼ and 100, and the markets gripped by fears of tighter money conditions as seasonal credit demands build up in the months ahead, the Treasury proceeded during May with a succession of short-term financing moves designed to meet immediate requirements. These included:

1. Offer of a new and more attractive "B" series Savings notes beginning May 15;
2. Raising sights on the amount to be borrowed on increased 91-day Treasury bill issues from $1 billion through June 30 to $2.3 billion through July 16;
3. Exchange offering of new 2⅝ per cent one-year certificates of indebtedness to holders of $5 billion certificates falling due June 1 and $700 million Treasury bonds called for payment June 15;
4. Scheduling an issue on June 3 of $800 million Tax Anticipation series Treasury bills due September 18 and acceptable in payment of September 15 taxes.

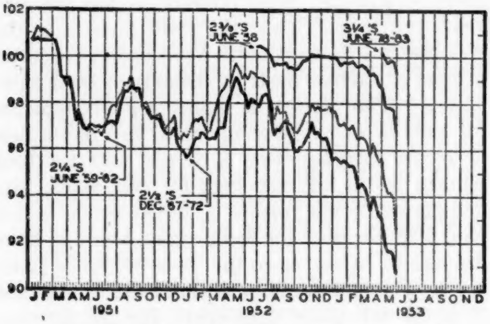
The new "B" series Saving notes, now on continuous sale, supplant the series "A" Savings notes which had been offered on tap for two years previous. This is the third time since the war that the Savings notes have been revised on a more attractive basis to strengthen their sales appeal. The Series B notes are redeemable for cash or in payment of taxes, and pay a rate of return ranging from 2.16 per cent for four months up to 2.47 per cent for two years. Redemptions of the former A series notes, which paid 1.88 per cent for three years' holding, have drained $1 billion from the Treasury since January 1. The evident hope is that sales of the new B series will more than cover further redemptions of the A series and thus help deficit financing.

Borrowing on Treasury Bills

On the four new 91-day bill issues put out during May the Treasury sold $600 million over and above the amounts maturing. Plans call for raising an additional $1.1 billion on increased 91-day bill issues during June and $500 million during July. Despite the increased issues, the interest cost on the bills sold during May progressively declined from a peak of 2.35 per cent on the issue dated May 7 to 2.08 per cent on the issue dated May 28. This decline reflected an abnormal demand for investment media of the shortest term and most liquid character.

Aside from the increased issues of regular 91-day series Treasury bills, it was announced on May 26 that an $800 million issue of Tax Anticipation series Treasury bills, due September 18 and acceptable in payment of September 15 income tax instalments will be sold for cash on June 3. This is the first time that the Treasury has felt the necessity to anticipate September tax revenues. In each of the past two years the heavier surplus revenues of the March and June tax periods have been anticipated by the sale of special series Treasury bills. This June, $2 billion of revenues will be absorbed by redemptions of such bills.

These borrowings on bills must have been a reluctant choice for the Treasury, which is committed to relieving the weight of short-term indebtedness as suitable opportunity arises. Under the demoralized market conditions prevailing in May, however, there was no real alternative. As the chart shows, bond prices moved to successively lower levels during May under the impact of advancing mortgage loan rates, official confirmations of a $6 billion budget deficit in the coming fiscal year, a sustained volume of State and municipal security flotations, a tendency of business borrowers to anticipate a squeeze and to borrow ahead, and associated pressures on lending institutions.



Closing Bid Prices, Selected U.S. Government Bonds

The 2⅝ Per Cent Certificates

The offering of the 2⅝ per cent one-year certificates, dated June 1, in exchange for $5 billion certificates maturing June 1 and $700 million bonds called for payment June 15, was announced after the close of trading May 18 and subscription books were open to holders of the maturing certificates and bonds for a three-day period, May 20-22. It was apparent almost from the start that the Treasury was going to experience a heavy rate of "attrition" or cash redemptions at maturity. Demand for the 2⅝s was insufficient to produce premium bids for the maturing certificates and bonds, many of which had been acquired by corporations to cover June tax payments.

On May 28 the Treasury announced that exchange subscriptions for the new 2⅝s totalled $4.9 billion, leaving $800 million maturing certificates and bonds to be paid off in cash. The Federal Reserve Banks exchanged holdings estimated at $1.1 billion leaving a subscription total from the public at large of $3.8 billion out of $4.6 billion, an 82 per cent result. This compares with the unusually favorable exchange percentage of 97 per cent realized on the $8.9 billion certificate refunding carried out February 15. It was this disappointing reception of the 2⅝ per cent certificate that led the Treasury to advance its plans for borrowings on Treasury bills as previously discussed.

Fears of Money Squeeze

Some observers expressed the feeling that the Treasury, faced by criticisms that it has been offering excessive rates on new borrowings, had cut the rate too fine and might have held the attrition down to more normal proportions with a 2¾ per cent one-year rate. On paper, however, in terms of the general structure of yields on government securities at the time, 2⅝ per cent looked like a fully adequate one-year rate.

Actually the Treasury was confronted by a difficult if not impossible situation — a run for liquidity based on fears that the Federal Reserve authorities might allow loan funds to become entirely unavailable, or prohibitively costly, in the months ahead.

While the 2⅝ per cent certificates due June 1, 1954 went begging for buyers, there was a strong demand for Treasury bills at rates below 2⅛ per cent for August, 1953 maturities all the way down to 1½ per cent for June maturities. The 2⅝s could easily have been underwritten by the banks against increased borrowings from the Federal Reserve but here possibilities of discount rate advance entered into the equation as well as, and perhaps more importantly, the Federal Reserve's policy of complaining to banks that borrow too much or too regularly. These criticisms, however well justified they may have been in any particular case, created apprehensions that the Federal Reserve, after policing discounts down, might follow a narrowly restrictive policy this autumn when seasonally-expanding credit requirements have to be met. The effect of such apprehensions was to make banks put stress on gaining liquidity, keeping investments short, tightening up on loans, and readying themselves for second half-year requirements.

Open Market Operations

On open market operations, the Federal Reserve early this year released $900 million from its Treasury bill portfolio in normal fashion to take up slack created by the seasonal return of currency. Thereafter, apart from temporary loans to the Treasury during the March tax period, the Federal Reserve maintained its holdings of government securities substantially unchanged through the close of April. During May the Federal Reserve made $157 million outright purchases of Treasury bills and also added $125 million to holdings under repurchase contract.

These May open market purchases contributed to the decline in Treasury bill yields, made

it easier for banks to reduce their borrowings, and suggested that the authorities were not unmindful of the practical problems of financing second half-year requirements.

Assuredly, the Federal Reserve authorities have a difficult situation: a high-flying business boom, that demands the brakes of credit restraint, complicated by heavy public debt maturities and a sizable Federal deficit. The best lesson out of the experience is the necessity of a balanced budget for economic stability in this situation.

The Credit of the U. S. A.

The ¼ to ½ per cent rise in the general structure of money rates since the year-end, and the associated decline in bond prices, stirred further controversy during May. While in April the criticism was leveled mainly at the Treasury, for paying 3¼ per cent on a $1 billion issue of thirty-year bonds, in May the attack turned to the Federal Reserve, for permitting the rise in market rates of interest. On May 11 Senator James E. Murray of Montana and Representative Wright Patman of Texas, on behalf of a group of twenty Senators and Congressmen, introduced a resolution directing the Federal Reserve Board and Open Market Committee to support the prices of United States government securities at par.

The resolution collides head on with what W. Randolph Burgess, Deputy to the Secretary of the Treasury with responsibility for public debt questions, has described as "the first rule of Treasury policy", namely that the Federal Reserve System shall be free to exercise its policy without interference. This means, he states, "that the Treasury must sell its securities in the market, at the going rate of interest, and not at an artificial rate supported by the Federal Reserve System."

The Arguments

The Murray-Patman resolution centers on the theme that the credit of the United States of America is endangered and requires the support of the Federal Reserve System. The sponsors, however, spray their fire and present their case from a number of different angles. Among points they make are the following:

1. Millions of loyal and patrotic American citizens supported their government during World War II by buying government bonds and have continued to do so in the postwar period.

2. The Federal Reserve System has impaired the credit of the United States of America by refusing to buy its proper share. It "dumped" $900 million government securities during the first quarter of 1953 and refrained from buying any new government securities.

3. The decline in government securities below par has seriously impaired the capital position of those with investments in previously issued government securities.

4. Federal Reserve policy has made it easier for banks, insurance companies, corporations and private investors to obtain higher interest rates and profits on money loaned to the government.

5. The Federal Reserve's policy will result in "vast additional expenditures" by the Federal government for interest and has also helped to bring about "a dangerous rise" in interest rates on funds borrowed by farmers, home builders and buyers, business men (with emphasis on small business), and local governments.

6. This policy violates the purposes of the Congress in the creation of the Federal Reserve System, is inconsistent with the maintenance of maximum production and purchasing power and may tend in combination with other factors to bring on a decline in business activity and to accentuate the deflationary trend in American agriculture.

7. The policy of supporting U.S. government securities at par will not only cost the taxpayers nothing but will also result in a saving to the taxpayer, profit to the Treasury and provide invaluable insurance against the threat of future depression, foreclosures, bankruptcies and unemployment.

Keeping Faith with the Bondholder

The government bonds having the widest distribution among the "millions of loyal and patriotic citizens" are the series E Savings bonds designed for individual investment and their predecessor series A-D bonds. The number of purchasers of such bonds at one time was estimated as high as 85,000,000. The Savings bonds have a scheme of penalties, in the shape of a lower rate of return, for redemption in advance of maturity. But they involve no risk of market price fluctuation. The Treasury has been faithful in its performance of its obligation to redeem Savings bonds at maturity, or in advance of maturity on the redemption schedule. The risk to the Savings bond holder lies in loose fiscal policies of the Government, undermining the value of the invested dollar.

The record of the dollar invested in Savings bonds has not been a reassuring one. As the table on the following page indicates, Savings bond holders generally have found that the promised interest return has been eaten up by inflation, not to mention the obligation to pay income tax on the nominal return. For example, a $100 Savings bond bought for $75 in 1942 (next to the last line on the table) had a maturity value of $100 in 1952. For an individual having other income sufficient only to place him in the initial personal income tax bracket, the income tax on the $25 accumulated interest amounted to $5.55 leaving net proceeds of $94.45. When account was taken of the 62.8 per cent increase in the price level as measured by the official cost of living index between 1942 and 1952, the

holder found that an "inflation tax" of $36.43 had been levied against him. Thus, the upshot of the whole transaction is that for the $75 he gave up in 1942, he got back in 1952 even less in real buying power than he started out with.

In 1942, to be sure, we were at war, and many consumers' goods were unavailable in the markets. The failure of the Savings bond buyer to realize a real return on his money can be called a patriotic sacrifice. However this may be, he cannot overlook that the inflation process has gone on, with few interruptions, over seven postwar years. If there has been any violation of faith on the part of the Government toward the bondholder, it has been through tolerating inflation. The experience has made it harder to sell Savings bonds although the announced determination of the new Administration to hew closer to the path of prudent economic policy has given visible stimulus to Savings bond sales.

It would be bad news for the Savings bond holder if the Federal Reserve were to go back into the business of pegging prices of marketable government bonds to cheapen the cost of Treasury financing. Of this, fortunately, there appears to be little present risk. It took two Congressional investigations, and a public controversy which raged on and off for three years, to establish the inflationary perils of pegging bond prices at fixed levels. Responsible public officials have turned their backs to this sort of manipulation at the eventual expense, mainly, of the saver.

If anything is impairing the credit of the United States today it is the persistence of budget deficits. Any Senator or Congressman earnestly concerned with protecting the credit of the nation has abundant work cut out for him in finding frills, wastes, and programs of marginal utility in the Federal establishment.

Federal Reserve Policy

On the second point, the Federal Reserve's $900 million sales of government securities early this year — which the sponsors of the resolution say were "dumped" — were released gradually into the market to absorb idle loan funds accumulating in the banks from the usual post-Christmas return flow of currency. In normal course, as seasonal pressures mount, these securities presumably will be replaced. The pattern is a familiar one. In the first two months of 1952 the Federal Reserve sold more than $1 billion government securities and later in the year bought $2 billion.

It is true that the Federal Reserve authorities have been conspicuously less active this year in the government securities market and less inclined to put out more money to relieve the bond price declines and interest rate advances which are a normal feature of business boom. In adopting this policy they have acted on the precept, as stated by Federal Reserve Board Chairman Martin on May 6, that: "when an economy is running at peak levels of production and employment, creating more money will not create more things to buy. It can only bid up the prices of available supplies."

Bond Prices and Interest Rates

The third and fourth items enumerated stand in apparent conflict; taken together they make the useful point that Federal Reserve "hard money" policies not only have brought higher interest rates to lenders and investors but also declining bond prices and a sense of stringency. These are all natural results of an excess of demand over supply of loan funds under a Federal Reserve policy that resists inflation of the currency to accommodate the excess of demands. The lender gets a higher rate on new loans, and on replacements of maturing investments. On investments which still have some years to run at lower rates, he finds himself "locked in" except to the extent that he is willing and able to accept losses. While the lender may feel an uncomfortable stringency, and may wish that he had larger percentages of short-term securities, capital positions have not been "seriously impaired". They

Return on 1935-43 Savings Bond Issues After Income Tax and "Inflation Tax"

Bought for $75 in	Maturity value of $100 in	Initial (lowest) personal income tax rate	Income tax on $25 interest	Maturity value less income tax	"Inflation tax" — increase in cost of living index over the 10 years†	Amount of "inflation tax"	Maturity value less income tax & "inflation tax"	Dollars of original investment lost	Average annual rate of loss
1935	1945	23.0%	*	$100.00	34.8%	$25.82	$74.18	$ 0.82	.11%
1936	1946	19.0	*	100.00	40.6	28.88	71.12	3.88	.52
1937	1947	19.0	*	100.00	55.5	35.69	64.31	10.69	1.48
1938	1948	16.6	*	100.00	70.5	41.35	58.65	16.35	2.18
1939	1949	16.6	*	100.00	71.4	41.66	58.34	16.66	2.22
1940	1950	17.4	*	100.00	71.6	41.72	58.28	16.72	2.23
1941	1951‡	20.4	$5.10	94.90	76.5	41.13	53.77	21.28	2.83
1942	1952‡	22.2	5.55	94.45	62.8	36.43	58.02	16.98	2.26
1943¶	1953‡	22.2	5.55	94.45	53.6	32.96	61.49	13.51	1.80

* Income tax exemption allowed on interest from $5000 or less principal value of Savings bonds issued 1935-40. † 1945 cost of living index adjusted, according to the findings of the President's Committee on the Cost of Living, to show the wartime effects of changes in quality, availability of consumer goods, etc. ‡ Continued interest accumulation authorized for an additional ten year period. ¶ Cost of living index for 1953 based on figures for first four months.

will not be, barring a broad credit deflation forcing heavy liquidation of bonds on a falling market. No informed person believes that the Federal Reserve authorities are intent upon producing any such result. Meanwhile, the benefits from higher interest rates on new loans and investments give banks and financial institutions latitude for building reserves to absorb such losses on bond holdings as need to be taken.

As for Federal interest costs, under point 5, the best course is to overbalance the budget and work off some of the debt. It would be manifestly unjust to indulge another round of inflation further to ease the burden of the debt. The saver's "inflation tax" has already been oppressively heavy.

With private borrowers, States and municipalities, if higher rates and difficulties of financing lead to deferments of projects, there will be more things on the shelf to be launched when business takes an adverse turn. Also, credit standings can be that much stronger. The "dangerous rise" in the area of credit is not the rise of interest rates but the growth of indebtedness. This needs to be slowed unless we wish to catapult ourselves into a really serious setback.

Purposes of the Federal Reserve

Points 6 and 7 enumerated are incorrect so far as they neglect the value of money as a policy consideration and imply that the purpose of the Federal Reserve should be to use its monopoly powers of money issue to load the dice perennially in favor of the debtor and to keep a full head of steam in the inflation boiler at all times. This is the road to "future depressions, foreclosures, bankruptcies and unemployment". These things germinate out of excessive growth of indebtedness which is the very thing the sponsors of the resolution have to advocate.

How, indeed, are "depressions, foreclosures, bankruptcies and unemployment" to be avoided? How else, save by checking excessive growth of indebtedness in time of booming prosperity? Chairman Martin, speaking at Boston last month, had the following comments bearing on this point:

> The purpose is to see that, so far as Federal Reserve policies are a controlling factor, the supply and flow of credit is neither so large as to induce destructive inflationary forces nor so small as to stifle our great and growing economy . . .
>
> Inflation is a sneak thief. It seems to be putting money into our pockets when in fact it is robbing the saver, the pensioner, the retired workman, the aged — those least able to defend themselves. And when deflation sets in, business man, banker, worker, suffer alike, as most of us here know from the early thirties.
>
> All of that is an old story, to most of us, yet there are voices being heard even today that seem to say that just a little more inflation won't do any harm — or that the price of even a few ounces of prevention is too high. What we are seeking to prevent in the end, of course, is deflation.

Douglas on Market Rigging

The idea that the credit of the United States needs the support of Federal Reserve bond price pegs is one that figured in the investigation pursued by a subcommittee headed by Congressman Patman a year ago. Senator Paul H. Douglas of Illinois, a member of the subcommittee, analyzed this approach in the following language:

> . . . there are two attitudes of mind with regard to the Government bond market — one being that the Government should borrow at rates established by the market, submitting itself to the same disciplines as private borrowers; the other being that the Government, in its borrowing activities, should have an insulated market . . .
>
> The word "insulation" . . . is soft, pleasant, and enticing, and the report is quick to point out that it wants the insulation to be reasonable. The word "rigging" would be harsh, brutal, and repulsive. Yet I think the truth is, if we are not very careful, that the principle of insulation will become the practice of rigging. We will have the creation of an artificial market by devices resolutely denied to private firms but eagerly adopted, in the future as they have been in the past, by the Government itself.
>
> The principle of insulation presents the grave danger of evils that are catastrophic in their realization. One danger is that the Government cannot, in the end, produce rigged markets for its own securities and then hold the private economy to a standard of financial morality that it refuses for itself. The end result of such a double standard of financial morality is simply the destruction of confidence in the integrity and purposes of Government. A particular phase of this destruction of confidence relates to the Government's credit: insulated and rigged markets do not in the long run maintain but rather destroy the credit of the Government.

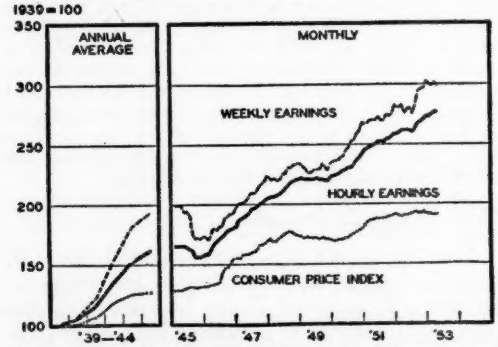
New Wage Demands

For the eighth time since World War II, organized labor is driving again for wage increases and improved fringe benefits. With the opening last month of collective bargaining talks between the United Steelworkers of America, C.I.O., and the steel companies, and the recently concluded auto industry settlements, the season for "big league" labor-management negotiations is under way in earnest. The outcome of the steel talks will go far towards setting a pattern for industry generally.

In the postwar years the unions have employed, successively or in combination, five principal justifications for their annual demands for wage increases and other benefits, to wit: (1) need to maintain take-home pay as overtime declined after the war; (2) corporate "ability to pay", as measured by "excessive" profits; (3) increased

productivity; (4) need to keep pace with rising living costs; and (5) need to maintain or bolster purchasing power as a means of preventing depression. Each year they have based demands on whichever arguments seemed to offer the best chance of success, in the prevailing economic climate; and when the climate changed the argument has changed with it. Thus they have wanted higher hourly pay when people were working longer hours, but higher weekly pay when the work week was declining. They argued that employers could pay more out of alleged "savings" resulting from curtailment of overtime after the war, although during the war they had claimed that overtime resulted in "savings" through lower cost production. They demanded higher wages when living costs were rising, as in 1947, 1948, and 1950, and higher fringe benefits when living costs were falling, as in 1949.

These tactics, in an environment of full employment, have paid off very well. The accompanying chart, comparing indexes of hourly earnings and weekly earnings of manufacturing workers as reported by the U.S. Bureau of Labor Statistics with consumer prices or cost of living, shows that both during the war and postwar periods wages gained substantially over living costs, representing a rise in "real" wages for workers covered in the survey, with a large increase in fringe benefits to boot.



Indexes of Hourly and Weekly Earnings of Manufacturing Employes and of Consumer Prices. 1939 Average = 100. Latest Plotting April, 1953

Issues in 1953

This year the unions' objectives and arguments again are being varied to suit the economic climate. The chief difference as compared with earlier postwar years is that the rise in living costs has leveled out, which undercuts that argument for wage increases. In fact, labor leaders envision the possibility that the "escalator" idea of tying wages to the cost of living index may not only be played out, but may even work in reverse. Hence they are now attempting to "freeze in" past gains, and to change escalation provisions in contracts so that the escalator will work only in an upward direction. At the same time they turn increasingly to alternative sources of wage and benefit increases. The recent United Auto Workers negotiations with the auto industry illustrate the point. These settlements put a floor under escalation losses by writing 19 cents of past hourly escalation gains into basic wages. They provided faster escalation of wages above than below present levels, increased annual productivity increments, and gave some additional pension benefits.

With the living cost argument undercut, the unions are basing their claims for new wage and benefit increases mainly on (1) increased productivity, and (2) the need of providing additional purchasing power for the workers as defense spending falls off, in order to maintain prosperity.

George Meany, president of the American Federation of Labor, sounded the opening gun of the 1953 labor campaign at a meeting of the A.F.L. Executive Council last February, when he said: "If wages fail to keep pace with productivity, workers will not have enough to buy goods, markets will collapse, factories will be closed, mass unemployment will follow, and a depression will result." The steel workers, in presenting their demands, have echoed essentially the same theme.

Gains in Productivity

The productivity argument raises the question of principle in distributing the rewards of productivity. It has often been pointed out that the basis for higher wages must be increased productivity, for only by greater output per manhour can more goods per capita be available to raise real incomes throughout the economy. But there are various ways in which productivity gains can be distributed. They should, as far as possible, go to everybody.

Not only those who are factory workers contribute to the improved efficiency of our economy, but also school teachers, repairmen, farmers, public servants, those whose savings provide the necessary capital for new plant and equipment, and all who work at tasks for which there is an economic demand. Cutting the cake of productivity should result in improving the real income of all these persons, not just a few. This is best done by distributing some of the gains of productivity in the form of lower prices, to increase the buying power of all groups in the economy. This principle was recognized at a recent conference on productivity held in Switzerland by the International Labor Organization and reported in its I.L.O. News, as follows:

> The experts agreed that it was of utmost importance, if higher productivity was in fact to lead to higher living standards, that its benefits should be equitably distributed among capital, labor and consumers . . . The experts expressed the view that the share of workers in the benefits of higher productivity might take the form in part of higher wages, in part of lower prices for the goods produced, and in part of better working conditions, including shorter hours, social services, and improved housing.

Any theory that labor is entitled to a lion's share of productivity gains must also be balanced against the just claims of capital, which has provided the new tools and machinery that have lightened the burden of labor's toil and been largely responsible for its vastly increased output. The productivity of the American worker has been raised not because he works harder or longer or necessarily with more skill, but mainly because he has at his disposal a greatly enlarged and costly investment in equipment and power. The steel industry alone, from the end of the war through this year, will have expended over $5½ billion for increasing the capacity and efficiency of the country's steel plants. Are not the owners of these companies entitled to share in the return on this huge additional investment? Lacking such incentive, who would provide the tools for production and take the risks of enterprise without which progress would come to a halt?

Purchasing Power Argument

The second theory, that the way to maintain prosperity is to increase purchasing power by boosting wages, may sound plausible to many, yet anyone who has had to meet a payroll can spot the "catch" in a minute. He knows that increasing wages means, other things being equal, increasing costs, and that unless he can increase prices correspondingly he is in trouble. Profit margins shrink, and the incentive to expand and employ more people is discouraged, thus weakening a major support to business momentum.

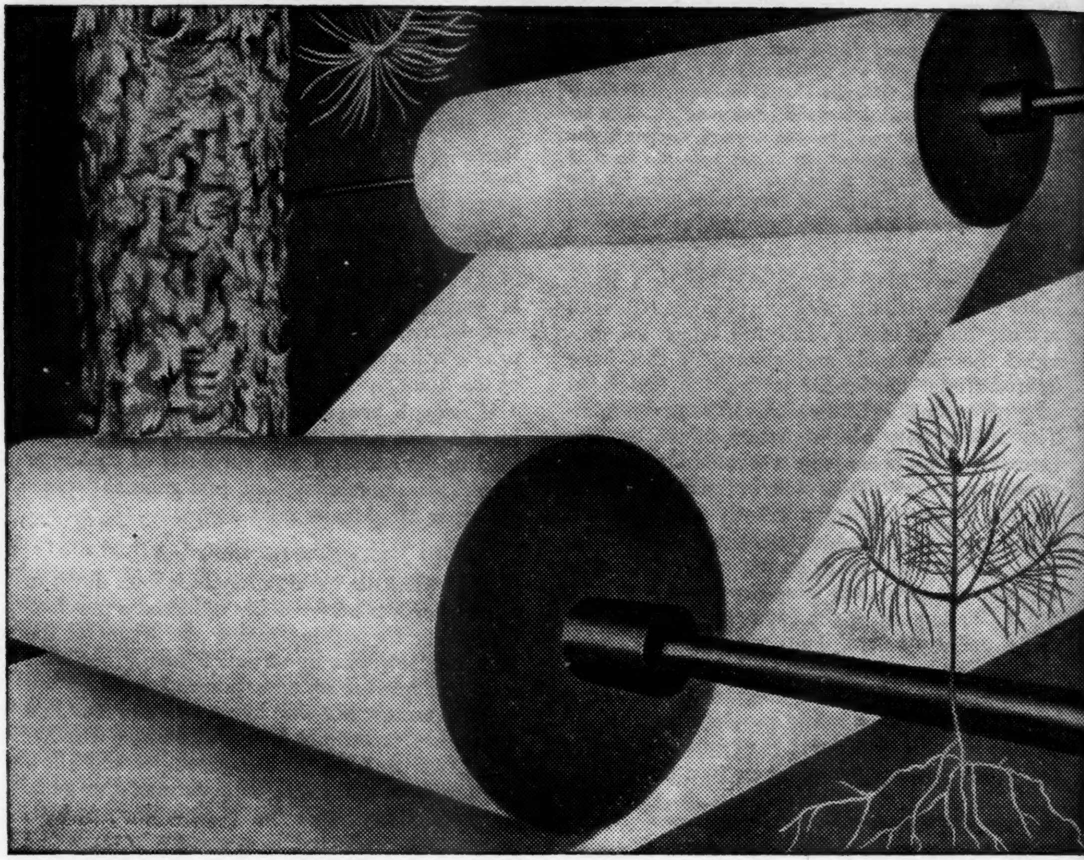
The theory may seem to work so long as increased costs can be passed on in prices. But this is at the expense of the consumer. Since not everyone can get an increase at the same time and in the same amount, and those whose incomes are inflexible get none, a great many people find their ability to buy actually reduced. A new round of wage increases in autos and steel, that sets a pattern for other highly organized industries, may temporarily put more dollars in pockets of a favored minority of American wage-earners, but if accompanied by increased prices, will mean depreciating the buying power of the dollars of all Americans.

If enough people are unable or unwilling to buy because prices are too high, that also would lead to the accumulating surpluses of consumer goods, mass unemployment, and general depression that Mr. Meany talks about.

The Crucial Question

Thus what the question finally comes down to is whether it is better to try to increase purchasing power by pushing higher the wages of the relatively few who by virtue of their strong hold in key industries are in a position to adopt aggressive tactics, but who by such tactics may find themselves priced out of the market; or whether it is better to hold the line on wages and allow the forces of increasing competition, the gains in productivity, and the decline in materials prices to be reflected in generally lower living costs which will be of benefit to all.

In the first case, the risk is one of creating new distortions in the economy, with disruption of trade relations and loss of purchasing power when people can no longer do business with one another. In the second, such risks are minimized, and the basis more surely maintained for the balanced relations which are necessary if business is to enjoy broad markets and labor is to have full employment.



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